



Section-by-Section Analysis

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Overview

Approximately 50 billion checks are written in the United States each year, and significant economic resources are expended in their collection and return. Each night, checks are processed by depository banks and various intermediaries and then transported for presentment to paying banks across the country. ¹ Similarly, checks that, for a variety of reasons, cannot be paid are returned to depository banks. While the banking industry has applied technology to improve the check collection and return process, the check collection system's legal framework still requires that banks physically present and return checks unless they have obtained agreements to do so electronically. Banks, however, have found it difficult to obtain such agreements on a large scale. In addition, some bank customers still prefer receiving their paper checks after they have been paid and their paper check deposits if they have been returned unpaid. These obstacles have hindered the widespread adoption of check truncation by the banking industry. The Federal Reserve Board has developed a draft Federal law, the proposed Check Truncation Act (the "proposed Act"), that would remove certain legal impediments to check truncation. ² Removing these impediments would facilitate the use of check truncation and the electronic collection and return of checks. This should lead to overall payments system improvements.

The proposed Act is designed to facilitate check truncation, to foster innovation in the check collection system without mandating the receipt of checks in electronic form, and to improve the overall efficiency of the nation's payments system. In drafting a law to achieve these purposes, the Federal Reserve Board strove to ensure, to the extent practicable, that a bank and its customer would be in the substantially equivalent legal and practical position regardless of whether or not they received the original check. The Board also strove to ensure that the burdens associated with the proposed law did not outweigh the associated benefits for either banks in the aggregate or their customers in the aggregate. The Board used as an additional guiding principle that the proposed law should provide that banks that choose to convert a check to, or receive a check in, electronic form should internalize, to the extent practicable, the costs and risks related to the creation of the substitute check, because they receive most of the associated benefits.

These purposes and guiding principles were intended to guide development of a proposed law that would promote the use of electronics in the collection of checks while acknowledging that some payments system participants may prefer to continue receiving paper checks. While there might be substantial payments system benefits if most or all checks were truncated, certain payments system participants may not be able to achieve sufficient benefits to justify expending the resources required to modify their current processes. As a result, the proposed Act promotes payments system improvements without mandating greater use of electronic processing.

The Federal Reserve Board considered requiring banks to accept checks electronically, but

concluded that it is premature to mandate electronic check presentment and return at this time. Today, fewer than one-quarter of checks are presented electronically, using a variety of formats and communications protocols. Mandating electronic check presentment would require significant expenditures and operational changes in check processing practices by thousands of banks. In contrast, the proposed Act facilitates check truncation in a manner that makes significant operational changes optional, rather than mandatory. Banks creating substitute checks will need to make operational changes, but will only do so when they have a business case for creating substitute checks; recipients of substitute checks will process those checks in the same manner as if they were original checks. The Federal Reserve Board believes the proposed Act may help speed the voluntary adoption of electronic check presentment and return. Further legislation to promote electronic check presentment may be appropriate in the future to codify business practices once electronic check exchange agreements become far more widespread.

Highlights of the Proposed Act

Under the provisions of the proposed Act, banks could agree, as they can today, to send check images or information to each other electronically rather than exchanging original paper checks for forward collection or return. Today, these electronic exchange agreements often involve the transmission of payment data taken from the magnetic-ink character recognition (MICR) line of checks and may also involve the delivery or transmission of either the original checks themselves or electronic images of those checks. Under the proposed Act, however, banks could use electronics to streamline the check collection and return process even in cases in which they do not have electronic exchange agreements. The proposed Act facilitates this expanded use of electronics by creating a new type of paper document, called a "substitute check," that can be created from an electronic check image and that would be the legal equivalent of the original check. A legally equivalent substitute check would (1) contain an image that accurately represents all of the information on the front and back of the original check as of the time the original check was truncated, (2) contain a MICR line that would permit the substitute check to be processed on standard check-sorting equipment, (3) conform to industry standards for substitute checks, and (4) bear a legend that indicates that it is the legal equivalent of the original check. As a result, banks would be able to take advantage of the latest electronic check processing technologies by sending check images or information electronically to banks with which they have electronic exchange agreements and by sending substitute checks to banks with which they do not have such agreements. Banks that choose to receive checks in paper form would receive either original checks or substitute checks and, therefore, would be able to continue processing checks without modifying their back-office operations.

The proposed Act governs substitute checks but not checks in electronic form. Today, banks that present or return checks electronically do so under bilateral or multilateral agreements. These agreements would continue to be necessary under the proposed Act. Excluding electronic checks from the proposed Act's scope allows the banking industry to address liability and technical issues related to electronic exchanges through agreements, which the Board believes is preferable to broader legislative coverage that might hinder the adoption of new technologies in the future.

The proposed Act creates a warranty structure to protect against the risk of increased losses associated with the use of substitute checks. Like the current Uniform Commercial Code (U.C.C.) transfer warranties, the proposed Act's warranties are designed to "run with the check," that is, to follow the substitute check in any form, just as they would with an

original paper check. As discussed in more detail in section 4, the new warranties are given by the bank that creates a substitute check and by each bank that subsequently handles the check, whether in paper or electronic form, and receives consideration for it. The warranties are intended to protect against situations in which a substitute check does not meet the standards for legal equivalence or in which a party receives a duplicate request for payment after an original check has been truncated and converted to a substitute check.

The proposed Act also creates an indemnity structure, discussed in section 5, that is designed to address losses resulting from receiving a substitute check rather than the original check. These losses could occur because of a breach of warranty (such as the receipt of an illegible substitute check) or under other circumstances (such as in certain forgery cases when it is necessary to examine the handwriting on the original check for pen pressure or similar analysis). Like the warranties under the proposed Act, the indemnity would be given by the bank that creates a substitute check and by each bank that subsequently handles the check, whether in paper or electronic form, and receives consideration for it. The indemnity is intended to put parties in the position in which they would have been had they received the original check rather than the substitute check. Therefore, the indemnifying bank may satisfy the indemnity either by paying the amount of the indemnity, as described in section 5, or by producing the original check (or, in certain cases, a combination of both). A bank that creates substitute checks may arrange to share warranty or indemnity liability with other banks that are part of its electronic exchange agreement.

The proposed Act also provides an expedited recredit procedure for consumer accounts (discussed in section 6). Current law generally permits consumers to make claims against their banks for improper charges to their accounts. Banks have an incentive to resolve these claims quickly to avoid wrongful dishonor or other liability. Nevertheless, consumer groups have noted that banks do not always resolve problems promptly. They have stated that erroneous account charges can be particularly harmful to low-income consumers who cannot maintain sufficient funds in their accounts to cover such charges. The expedited recredit procedure is intended to mitigate the effects on consumers of any potential problems associated with the receipt of substitute checks. The proposed Act requires a bank to recredit a consumer, within a specified period, when a consumer makes a good faith claim that a loss has been incurred because the consumer's account was debited improperly for a substitute check that was provided to the consumer. The expedited recredit is available only if production of the original check is necessary to determine the validity of the claim. (If the claim's validity can be determined from the substitute check, then the consumer is in no worse a position than if he or she had received the original check.)

The proposed Act also provides an expedited recredit procedure for banks (discussed in section 7). This procedure permits a bank to obtain expedited recredit from a previous indemnifying or warranting bank when the bank is obligated to provide expedited recredit to a consumer.

Finally, the proposed Act has four special provisions for Treasury checks, to meet the particular needs of the Treasury Department (discussed in section 13). The first provision allows banks to truncate Treasury checks, but requires banks that do so to send the originals of those checks to a Federal Reserve Bank for safekeeping. The second provision specifies that a bank that truncates a Treasury check warrants that it has sent the original to a Federal Reserve Bank for safekeeping. The third provision allows the Secretary of the Treasury to write regulations with respect to Treasury checks to implement the provisions of the

proposed Act to further the proposed Act's purposes. The fourth provision specifies that the Secretary of the Treasury has the authority to extend the effective date of the proposed Act with respect to Treasury checks.

Benefits

The proposed Check Truncation Act may result in substantial payments system benefits, depending on the extent to which banks take advantage of provisions of the proposed Act to expand the use of electronics in the collection and return of checks. The proposed Act should result in faster collection and return of checks and lower costs in the long run; in addition, the proposed Act would reduce banks' reliance on air and ground transportation for collection and return of checks. The more rapid check collection and return process could be accomplished in many ways, with benefits likely accruing to both banks and their customers.

There are numerous ways a bank could take advantage of the proposed Act to streamline its check processing operations. For example, consider a bank that needs to present or return checks to a distant bank that does not accept check images or information electronically. Under the proposed Act, the bank would be able to use electronic processing throughout its operations and transmit the electronic check information and images to an intermediary, located near the distant bank, with whom it has an agreement to do so. The intermediary would print substitute checks for physical delivery to the distant bank. Thus, the sending bank would be able to take advantage of faster collection and other benefits of electronic processing, while the receiving bank would be able to continue processing paper checks because substitute checks could be processed the same way original checks are processed.

A bank could use substitute checks not only to present or return checks but also to improve its own internal operations. For example, a paying bank could run its returned check file against its image system to create substitute returned checks. Doing so would eliminate the need to run all the checks presented on the previous day through its sorters to pull the small number of checks that must be returned unpaid. A bank might also be able to restructure its branch network to significantly reduce its infrastructure costs. A bank's branch and ATM networks would no longer need to be tied geographically to its processing centers, because information and images on checks could be transmitted electronically to processing centers to create substitute checks. A bank would be able to selectively use electronic check processing and substitute checks when it is cost-effective to do so, and could transport original checks using less time-critical (and potentially less frequent) transportation options. As a result, a bank could reduce its operating costs, with savings passed on to shareholders in the form of higher returns or to customers in the form of lower fees.

The branch and ATM network restructuring noted above could benefit customers as well. For example, banks could offer customers broader deposit options or extended deposit cutoff hours for certain checks. Such changes could result in some checks being credited one day earlier, some checks clearing one day earlier, and interest accruing one day earlier for some checks deposited in interest-bearing accounts. Banks may also be able to provide more timely information to both depositors and drawers. For example, banks may be able to provide customers with access to on-line images of deposits and payments before the delivery of paper statements or provide printed copies of checks deposited at ATMs on ATM receipts.

The proposed Act gives banks authority to create and use substitute checks in the forward

collection and return processes, but does not require them to do so. Each bank may decide whether to make use of this new authority, according to its own internal business case analysis. The outcome of a given bank's analysis is likely to depend on the bank's technology infrastructure and technology strategy. A few banks have already begun to use substitute checks, even though the formal legal structure is not yet in place. Many other banks may take advantage of the new authority given by the proposed Act shortly after it becomes effective. Some banks, however, may find that in the short run, it is not profitable to do so, but that it is profitable in the long run as technology and banking practices change. Because each bank will take advantage of the new authority only if its benefits outweigh its costs of doing so, the Board has not estimated the aggregate and sectoral net benefits of this authority. Further, because each bank's decision on how to make use of the new authority will be based largely on the bank's own proprietary information, it would be extremely difficult to develop a reliable estimate of the aggregate level of banks' adoption of the new authority at any time or the net economic benefits to be derived, even if such an analysis were desired.

Law Enforcement Considerations

While the proposed Act may result in an increase in the number of checks being truncated, the Federal Reserve Board believes that the proposed Act will not significantly affect law enforcement efforts involving fraudulent checks. Currently, under a typical check truncation arrangement, the original paper check is generally destroyed shortly after being truncated. By the time fraud is discovered and law enforcement has become involved for investigation or prosecution of cases related to fraudulent checks, often the originals of checks that are currently truncated have already been destroyed. Thus, the Federal Reserve Board does not expect the proposed Act to significantly affect law enforcement's existing ability to investigate and prosecute cases related to fraudulent checks. Moreover, to the extent the proposed Act speeds the collection of checks, it may reduce opportunities for some forms of check fraud by enabling its more rapid discovery.

Section-by-Section Analysis

Section 2. Definitions

The proposed Act incorporates the Uniform Commercial Code's definitions, except when the proposed Act specifically defines a term.

(1) Account--The term *account* is used in sections 6 and 7 and refers to the types of accounts for which consumers may receive expedited recredit. *Account* means a deposit account at a bank, such as a checking or savings account. Thus, the expedited recredit provisions would apply to a checking account on which a consumer wrote a check, as well as to either a checking or savings account into which a consumer deposited a check. *Account* does not include a credit account, such as a credit card account or a line of credit. Therefore, credit accounts are not eligible for expedited recredit under the proposed Act; consumers' rights related to credit accounts, however, are addressed by the Truth in Lending Act and the Board's Regulation Z. Despite the proposed Act's distinction between deposit and credit accounts for purposes of its expedited recredit provisions, a check drawn on either a credit account or a checking or savings account may be converted into a substitute check.

(2) Bank--The term *bank* includes commercial banks, savings institutions, and credit unions located in a state. The definition also includes Federal Reserve Banks, Federal Home Loan Banks, and, when they act as payors, the U.S. Treasury, the U.S. Postal Service, and state and local governments.

(3) Banking day has the meaning given to this term in section 229.2 of the Federal

Reserve Board's Regulation CC. Regulation CC defines banking day as "that part of any business day on which an office of a bank is open to the public for carrying on substantially all of its banking functions." The cutoff hour for a banking day, for the purpose of determining when a consumer's claim for expedited recredit under section 6(b) is considered received, is as specified in section 229.19(a)(5) of Regulation CC.

(4) Business day has the meaning given to this term in section 229.2 of Regulation CC. Regulation CC defines business day as "a calendar day other than a Saturday or Sunday, January 1, the third Monday in January, the third Monday in February, the last Monday in May, July 4, the first Monday in September, the second Monday in October, November 11, the fourth Thursday in November, or December 25. If January 1, July 4, November 11, or December 25 fall on a Sunday, the next Monday is not a business day."

(5) Check--Checks must be drawn on or payable through or at an office of a bank. As a result, the term *check* includes credit union and insurance company payable-through drafts as well as mutual fund and credit card checks that are payable through a bank. The definition excludes checks drawn on banking offices outside the United States, checks that are not denominated in U.S. dollars, and noncash items.

(6) Consumer--Consumers are identified as a separate class of customers who are entitled to expedited recredit under section 6. A consumer's account is one that is used primarily for personal, family, or household purposes. Whether an account is a consumer account will in the first instance be determined by the bank holding the account based on the general purpose of the account, rather than on the purpose of any specific transaction affecting the account.

(7) Indemnifying bank means a bank that provides an indemnity under section 5 of the proposed Act.

(8) MICR (magnetic ink character recognition) line means the numbers, which may include the bank routing number, account number, check number, check amount, and other information printed near the bottom of a check in magnetic ink in accordance with generally applicable industry standards.

(9) Noncash item has the meaning given to such term in section 229.2 of Regulation CC. Regulation CC defines noncash item as "an item that would otherwise be a check, except that--(1) a passbook, certificate, or other document is attached; (2) it is accompanied by special instructions, such as a request for special advice of payment or dishonor; (3) it consists of more than a single thickness of paper, except a check that qualifies for handling by automated check-processing equipment; or (4) it has not been preprinted or post-encoded in magnetic ink with the routing number of the paying bank."

(10) Person means a natural person, corporation, unincorporated company, partnership, government unit or instrumentality, trust, or any other entity or organization.

(11) Reconverting bank--A *reconverting bank* is a bank that creates a substitute check (that is, it "reconverts" an electronic check image back into paper form). If a person other than a bank creates a substitute check, then the first bank that transfers or presents the substitute check is deemed to be the reconverting bank and makes the substitute check warranties and indemnities under the proposed Act. For example, if a bank's customer creates a substitute check for deposit into the customer's account at the bank, that bank will generally be the first bank to transfer or present the substitute check and receive consideration for it, so that bank is the "reconverting bank" under the proposed Act. A bank whose customer redeposits a returned substitute check, however, does not become a reconverting bank because another bank, by definition, previously transferred the substitute check for consideration and thus has provided the proposed Act's warranties and indemnities.

In the course of the check collection and return process, there may be two or more reconverting banks. This would be the case, for example, if the substitute check created by

the first reconverting bank were truncated, and the electronic information from that first substitute check were reconverted into a second substitute check.

(12) Returning bank has the meaning given to such term in section 229.2 of Regulation CC. Regulation CC defines returning bank as "a bank (other than a paying or depository bank) handling a returned check or notice in lieu of return. A returning bank is also a collecting bank for purposes of U.C.C. 4-202(b)."

(13) Substitute check--A *substitute check* is defined as a paper reproduction of the original check that:

- Contains an image of the front and back of the original check;
- Bears a MICR line containing all information required under generally applicable industry standards for substitute checks;
- Conforms to generally applicable industry standards for substitute checks (such as paper stock, dimension, MICR line indicators, and other features or requirements); and
- Is suitable for automated processing in the same manner as the original check.

These requirements are intended to enable recipients of a substitute check to process it as if it were the original check. Image statements, photocopies of checks, or other check images will generally not meet the definition of substitute check.

Initially, the Federal Reserve Board does not expect that generally applicable industry standards for substitute checks would require a substitute check to reflect, for example, the color or background design on the original check or characteristics that cannot readily be captured by an electronic representation (such as paper texture or pen pressure). Certain fraud detection features that currently exist on original paper checks, such as watermarks or microprinting, also may not survive the conversion into electronic form or the reversion from electronic form into a substitute check. The industry is investigating fraud detection features that survive imaging, and paying banks may choose to adopt such image-survivable features.

The requirement that the substitute check bear a MICR line applies to the substitute check's MICR line, not to the substitute check's image of the original check's MICR line. In other words, the substitute check itself must bear a machine-readable MICR line. One space in the MICR line, known as the external processing code (EPC) field or position 44, is reserved to encode information other than the paying bank's routing number, the drawer's account number, the check number, and the amount of the check. The Federal Reserve Board expects that the industry standards for substitute checks may use this reserved space to identify the check as a substitute check. If so, the information in this space on the MICR line of the substitute check may differ from the information, if any, in the same space on the MICR line of the original check.

One of the underlying assumptions of the proposed Act is that the banking industry, which has already adopted electronic check image standards, will adopt technical standards for substitute checks, the electronic exchange of check images and information, and electronic check image indorsements. The proposed Act relies on the development of these standards; the Federal Reserve Board understands that industry groups are already working to develop such standards, and expect to have trial or final standards in place by year-end 2002.

(14) State means a state of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or a territory, possession, or dependency of the United States.

(15) Treasury check means a check drawn on the United States Treasury.

(16) Truncate means to remove an original paper check from the check collection or

return process and in its place to send to a recipient a substitute check or, by agreement, information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check), with or without subsequent delivery of the original paper check.

(17) Uniform Commercial Code or U.C.C. means the Uniform Commercial Code in effect in a state.

Section 3. General Provisions Governing Substitute Checks

(a) No agreement required--This subsection permits a person to send a substitute check without the agreement of the recipient if a bank provided the requisite warranties. Therefore, a nonbank customer that creates a substitute check would need its bank's agreement before it could deposit that substitute check with the bank for collection. (As explained above, the customer's bank in this case would be deemed the "reconverting bank" under the proposed Act and would make the warranties under section 4 and indemnities under section 5.) The customer could, however, deposit a substitute check without its bank's agreement (such as in the case of the redeposit of a returned substitute check) if that substitute check was created by or on behalf of another bank and was transferred such that the other bank had already made the section 4 warranties with respect to that substitute check.

A paper reproduction of a check that does not meet the proposed Act's requirements for a substitute check cannot be sent to a recipient for forward collection or return without the agreement of that recipient.

(b) Legal equivalence--This subsection establishes the requirements a substitute check must meet to constitute the legal equivalent of the original check. If these conditions are met, any party may use the substitute check for all of the same purposes as it would use the original check, such as negotiating it or using the canceled substitute check as proof of payment.

A substitute check, as defined, must contain an image of the front and back of the original check, must bear a MICR line containing all information required under generally applicable industry standards for substitute checks, must conform to generally applicable industry standards for substitute checks, such as paper stock, dimension, MICR line indicators, and other features or requirements, and must be suitable for automated processing. A substitute check is the legal equivalent of the original check if, in addition to meeting the requirements of the definition of substitute check, it accurately represents all of the information on the front and back of the original check as of the time the original check was truncated and includes the following legend: "This is a legal copy of your check. You can use it the same way you would use the original check." Because the accuracy requirement refers to the state of the original check as of the time it was truncated, there is no expectation that the substitute check will be more legible than the original check. The text of the legend is intentionally direct and explicit; the language was drafted so that consumers could understand it easily.

A substitute check that does not bear the specified legend may still be machine-processed and would still carry all of the proposed Act's warranties and indemnities for substitute checks if it was used for forward collection or return and a bank received consideration for the check, even though it would not be the legal equivalent of the original check. Under section 4(a) of the proposed Act, a recipient of such a substitute check that suffers a loss because of the absence of legal equivalency would have a warranty claim.

As noted above, the check collection system's legal framework (articles 3 and 4 of the U.C.C. and Regulation CC) requires that banks physically present and return original paper checks unless they have obtained agreements to do so otherwise. This continues to be the case notwithstanding the recent passage of Federal and state electronic commerce

legislation. The Electronic Signatures in Global and National Commerce Act ("E-Sign") and the Uniform Electronic Transactions Act ("UETA") both provide that if a law, statute, or regulation requires retention of a check, it may be satisfied by the retention of an accurate electronic record of the information on the front and back of the check.³ Both E-Sign and UETA, however, specifically exclude any transaction governed by the payments articles of the U.C.C. (articles 3, 4, or 4A), such as check collection. Furthermore, both E-Sign and UETA by their terms affect only rules requiring the retention of paid checks, such as for recordkeeping or audit purposes, and do not create electronic or substitute payment instruments. The proposed Check Truncation Act, however, provides that a substitute check is the legal equivalent of the original check and is enforceable to the same extent as the original check without prior agreements to that effect--even in the collection process. Accordingly, the proposed Check Truncation Act resolves a major legal impediment to check truncation that exists notwithstanding E-Sign and UETA.

(c) Indorsements--This subsection requires the reconverting bank to ensure that the substitute check bears all indorsements applied by parties that previously handled the check, whether the check was handled in paper or electronic form. Lack of indorsement(s) does not affect the legal equivalence of a substitute check. Because a substitute check under the proposed Act would be subject to existing law as if it were the original check, the U.C.C. and Regulation CC indorsement requirements, including U.C.C. 3-203 and 4-205 and 12 CFR 229.35, would apply to substitute checks. The treatment of indorsements that are placed on carrier envelopes is being addressed by industry standards.

(d) Identification of reconverting bank--This subsection requires that a reconverting bank be clearly identified as such on the substitute check in conformance with generally applicable industry standards. A reconverting bank must ensure that any previous reconverting bank identifications are preserved. A clear identifier for the reconverting bank will make it easier to make a claim directly against the reconverting bank rather than making the claim back through the collection path followed by the substitute check. The placement on a substitute check of the reconverting bank identifier (for example, in the bank indorsement or on the face of the check) is being addressed by industry standards.

(e) Applicable law--This subsection provides that a substitute check that is the legal equivalent of the original check is subject to all other applicable Federal or state laws as if it were the original check, to the extent such law is not inconsistent with this proposed Act. A paying bank may dishonor a substitute check (for example, if it suspects forgery) to the same extent it could dishonor an original paper check under the U.C.C. Similarly, a paying bank that wrongfully dishonors a substitute check is subject to the wrongful dishonor provisions of the U.C.C. to the same extent as if it had wrongfully dishonored an original paper check. As another example, a returned substitute check would be subject to the Regulation CC requirement to include the reason for return, 12 CFR 229.30(d).

Section 4. Warranties

(a) Substitute check warranties--Under this subsection, any bank that transfers, presents, or returns a substitute check, and receives consideration for it, warrants that the substitute check meets the requirements for legal equivalence and that payment will not be requested for a check that has already been paid. These warranties are made to the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any indorser. Once a substitute check is created, these warranties flow through to subsequent parties regardless of whether the substitute check remains in substitute check form, is converted into electronic form, or is reconverted from an electronic image back into another substitute check. Furthermore, because a substitute check that is transferred for consideration is warranted to be the legal equivalent of the

original check and thereby subject to existing law as if it were the original check, all U.C.C. warranties applicable to the original check flow through to the recipients of the substitute check.

If a substitute check is converted to electronic form and subsequently reconverted again into a second substitute check, then the second reconverting bank and all subsequent banks warrant the legal equivalence of the second substitute check but not of the first substitute check. Thus, a subsequent party would have a claim on a reconverting bank only if the substitute check created by that bank did not meet the legal equivalence requirements. A reconverting bank would not be liable under this warranty if the legal equivalence defect is the fault of a subsequent bank that handled the check either electronically or as another substitute check.

The "no-double-debit" warranty is given by each reconverting bank and by any party subsequently handling the check in paper or electronic form. This warranty is not linked to a particular substitute check: Each reconverting bank thus provides the "no-double-debit" warranty regardless of whether the ultimate demand for double payment is based on (1) the substitute check created by that reconverting bank, (2) some other electronic or paper version of that substitute check or of the original check, or (3) the original check. Under section 4-401(a) of the U.C.C., a bank may charge its customer's account only for an item that is properly payable. A duplicate presentment (request for payment) is not properly payable (because the customer authorized only one payment).

The proposed Act provides additional protections to consumers who do not have truncation agreements with their banks in cases in which a double debit to the consumer's account results from a substitute check. In such cases, if a substitute check is properly paid and the original check from which the substitute check was created is subsequently also paid in violation of the "no-double-debit" warranty, the consumer holding the account may claim an expedited recredit under section 6 of the proposed Act and may enforce a warranty claim against the reconverting bank. If the order of presentment is reversed, such that an original check is properly paid and a substitute check created from the original check is later also paid, the result is the same: The consumer holding the account may enforce an expedited recredit claim as well as a warranty claim for breach of the "no-double-debit" warranty.

If any double debit results, in whole or in part, from the negligence or bad faith of an indemnified party, any damages owed by the reconverting bank to the party at fault are reduced in proportion to the amount of that party's negligence or bad faith, which may reduce or eliminate the reconverting bank's liability.

A reconverting bank may protect itself from losses caused by a bank from which it accepts checks electronically by including in its electronic exchange agreement with that bank provisions specifying that bank's warranties to the reconverting bank. A bank that accepts for transfer or presentment a substitute check created by its customer may protect itself by limiting which customers may create substitute checks and by entering into agreements specifying the liabilities of those customers that it permits to create substitute checks.

(b) Truncated Treasury check warranties--This subsection provides warranties relating to the truncation of Treasury checks. As explained below in section 13, the proposed Act permits truncation of Treasury checks but requires that the originals of those checks be sent to a Federal Reserve Bank for safekeeping. This subsection provides that a bank that truncates a Treasury check and receives consideration for it warrants that it has complied with the requirements of section 13 of the proposed Act.

This subsection applies only to Treasury checks. This subsection does not apply to checks drawn on accounts maintained by the Treasury at a commercial bank.

Section 5. Indemnity

(a) Indemnity--This section provides an indemnity for a loss incurred by the recipient of a substitute check, if the loss is due to the receipt of the substitute check rather than the original check. If the loss would have occurred even if the original check had been transferred or presented instead of the substitute check, the party incurring the loss would not have an indemnity claim, because that party is no worse off as a result of having received the substitute check. The absence of an indemnity claim would have no effect on that party's ability to pursue a warranty claim under the proposed Act or other claims under other applicable law.

The indemnity originates with the reconverting bank and, like the warranties, the indemnity "runs with the check." Each bank that subsequently handles a substitute check (in electronic or paper form) and receives consideration for it provides the indemnity. The indemnity is provided to all parties in the check collection and return stream, including the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any indorser. Like warranty claims, indemnity claims may be passed back through the collection and return chain to the first indemnifying bank. The indemnifying bank's liability, however, may be reduced by the negligence or bad faith of any indemnified party under the comparative negligence provisions of subsection (c).

An indemnity claim could arise when a bank in the check collection chain has breached a warranty. For example, if there is a breach of the "no-double-debit" warranty due to the creation of two substitute checks from the same original check, a drawer's account could become overdrawn, with resulting losses related not only to the particular payment in question but also to other payments. In this case, the indemnity would apply because the loss would not have occurred had the original check been presented for payment (because the original could only have been presented once). As another example, if there is a breach of the "legal equivalence" warranty because the image on the substitute check is inaccurate, a drawer attempting to prove payment may be unable to do so and may incur a loss. Again, in this case the indemnity would apply because the loss would not have occurred had the original check been presented.

An indemnity claim could arise even if there is no warranty breach. For example, if a customer claims that the drawer's signature has been forged, a paying bank may not be able to determine the validity of the claim by looking at the substitute check, even if it is an accurate image of the original check. The original check may be necessary for handwriting analysis. If the paying bank credited the customer's account for the amount of the check, it would have an indemnity claim. (Similarly, if the paying bank did not credit the customer's account, the customer would have an indemnity claim.)

As another example, if a check security feature were lost when a check was truncated, resulting in a loss to the paying bank that would not have occurred if the check security feature had been retained, the indemnity would apply.

(b) Indemnity amount--The amount of the indemnity depends on whether the loss is caused by a breach of a substitute check warranty under section 4 or by some other cause. If there is a breach of a warranty, the amount of the indemnity shall be the amount of any loss (including costs and reasonable attorney's fees and other expenses of representation) proximately caused by the warranty breach if that loss would not have occurred had the original check been transferred or presented. In the absence of a breach of a warranty, the amount of the indemnity shall be the amount of any loss, up to the amount of the substitute check plus interest and expenses (including costs and reasonable attorney's fees and other expenses of representation), if that loss would not have occurred had the original check been transferred or presented.

Any indemnified party may bring a claim under this section. The "proximately caused" standard in this subsection is to be interpreted consistently with the "proximately caused" standard in the 1990 Official Text of U.C.C. section 4-402(b).

This subsection attempts to strike a balance between permitting indemnifying banks to be able to ascertain potential liability on the one hand, and holding harmless banks and customers who receive substitute checks rather than originals on the other hand. Limiting the potential loss to the amount of the original check plus interest and expenses when there is no breach of warranty allows banks to make reasonable operational and risk decisions (such as how long to retain original checks that may be necessary in connection with a subsequent indemnity claim).

(c) Comparative negligence--This subsection reduces a party's indemnification in proportion to the amount of that party's negligence or failure to act in good faith that contributed to the loss. This provision is intended to allocate liability in a fashion similar to the comparative negligence provision in Regulation CC, 12 CFR 229.38(c).

The following is one example in which the comparative negligence provision would limit the indemnity provided by the indemnifying bank. Suppose a substitute check is converted into electronic form and later reconverted into a second substitute check. Further, suppose that the second substitute check created by the second reconverting bank is illegible, making the second reconverting bank liable under the proposed Act's indemnity. If the second reconverting bank attempts to make an indemnity claim against the first reconverting bank, the amount it could recover would be reduced by the amount attributable to its own negligence.

Under the U.C.C. and other applicable law, consumers also have duties--such as, for example, promptly reviewing their bank statements. Under this comparative negligence provision, the amount of a consumer's loss that may be recovered may be reduced if the consumer fails to comply with duties imposed by other applicable law.

(d) Effect of producing original check--If an indemnifying bank produces the original check, it is liable only for losses covered by the indemnity that have been incurred up to the time that the original check is provided to the indemnified party. An indemnifying bank that produces the original check under this subsection is entitled to a return of any funds already paid under the indemnity that are in excess of the losses incurred up to the time of production. The production of the original check does not absolve the indemnifying bank, however, from liability for breach of warranty under the proposed Act or under other applicable law.

For example, suppose a reconverting bank creates an illegible substitute check (from a legible original check), presents that illegible substitute check to the paying bank, and receives payment. Suppose that the drawer later claims to the paying bank that the check is not properly payable (because of forgery, alteration, or some other reason) and that production of the original check is necessary to determine the validity of the claim. If a consumer received the substitute check in a statement, the paying bank recredits the consumer's account under section 6 of the proposed Act and makes an indemnity claim under this section against the reconverting bank. If the consumer did not receive the substitute check in a statement, the consumer could still assert a claim that the item was not properly payable under section 4-401(a) of the U.C.C., because a substitute check under the proposed Act would be subject to existing law as if it were the original check. The paying bank, in turn, may make an indemnity claim against the reconverting bank under the U.C.C. presentment warranties (U.C.C. 3-417 and 4-208). If the reconverting bank cannot produce the original check, then it must indemnify the paying bank, as provided in section 5(b). If the reconverting bank cannot provide to the paying bank the original check, and the parties cannot agree on liability, they can turn to the courts to determine liability.

If in this example, however, the reconverting bank produces the original check, then it is entitled to a refund of any amount already paid that is in excess of the losses incurred up to the time of production of the original check. If the original check establishes that the charge to the consumer's account was in fact not authorized, then the paying bank may have

additional warranty claims against prior banks under the proposed Act and under other law (for example, under U.C.C. 3-417 and 4-208), which may offset the amount that must be refunded because of the production of the original check.

(e) Subrogation of rights--This subsection provides that each indemnifying bank is subrogated to the rights of any indemnified party to the extent of the indemnity. This subsection also requires each indemnified party to comply with all reasonable requests for assistance from the indemnifying bank in connection with any warranty claim the indemnifying bank brings against a warrantor. To limit potential losses, it is likely that indemnified parties will determine that responding quickly to such requests is in their own self-interest.

Section 6. Expedited Recredit Procedures for Consumers

The proposed Act permits a consumer in certain cases to obtain expedited recredit for the amount of a substitute check that is improperly charged to the consumer's account. These expedited recredit provisions of the proposed Act are limited to consumers, who are generally not in a position to negotiate with their banks the terms of their deposit accounts that affect the consumers' rights and liabilities, such as how payments are processed and charged to their accounts. Other customers, such as business customers, are generally better able to negotiate agreement terms with their banks that address their rights, responsibilities, and liabilities as part of their overall banking relationship. Even though some small businesses may not have significant negotiating power with their banks, it is difficult to draw a bright line between large and small businesses, and Congress has typically adopted customer protections for payment transactions for consumers only. Not only do the expedited recredit provisions apply only to consumers, but they also apply only in cases in which a consumer suffers a loss because a substitute check was charged to the consumer's account and when production of the original check is necessary to determine the validity of the charge.

The expedited recredit provisions of the proposed Act are further limited to those cases in which substitute checks are provided to the consumer. The expedited recredit provisions would not apply to consumers who do not receive their paid checks--that is, when they have agreed with their banks to have their checks truncated. Rather, the expedited recredit provisions are targeted only at those customers who receive something other than what they bargained for, that is, who receive a substitute check rather than an original check in their bank statements. Although consumers who agree to have their checks truncated would not be eligible for expedited recredit, they could nevertheless make warranty and indemnity claims under the proposed Act. Moreover, credit unions have been truncating checks for decades, and other banks have been truncating checks for many years. Millions of consumers have truncation agreements with their banks. These truncation arrangements generally work well, and the Federal Reserve Board is not aware of any pattern of problems or abuses that would justify Federal intervention to expand consumer rights for these accounts.

Consumer groups prefer that the proposed Act's recredit procedures apply more broadly to all truncated checks drawn on consumer accounts. These groups argue that limiting the expedited recredit provisions to substitute checks that are provided to the consumer would create an unintended incentive for consumers to choose account arrangements under which they receive their paid checks in their statements. On the other hand, some banks contend that the expedited recredit provision will facilitate check fraud and is unnecessary, arguing that provisions of the U.C.C. adequately protect consumers in the case of a double debit. In recognition of the concerns of both consumer groups and banks, the proposed Act is designed with a relatively narrow focus intended to balance consumer and bank interests and is not intended to modify how the law applies to existing

risks that are unrelated to the creation and transfer of substitute checks.

(a) When a consumer may make a claim--A consumer may make a claim for expedited recredit from the bank that has charged his or her account (the bank holding the account). A consumer may also make a claim against any other bank that provided a warranty or indemnity but, in those cases, would not be entitled to expedited recredit.

The consumer must make a claim for recredit in good faith, but is not required to prove his or her case conclusively to make a claim. To make a claim, a consumer must assert that the bank debited his or her account for a substitute check that was provided to the consumer and that the check was either not properly chargeable to the account or that the consumer has a warranty claim related to the substitute check. The consumer must also assert that he or she has suffered a loss because of the charge to the account in connection with the substitute check and that the original check is necessary to determine the validity of the charge or warranty claim.

For example, a consumer might make a claim for expedited recredit when the bank charges the consumer's account for a substitute check that appears to bear the consumer's authorized signature but that the consumer asserts is a forgery. In this case, examination of the original check may be necessary to determine the authenticity of the signature. On the other hand, if the authenticity of the signature can be determined from the substitute check, such as when the signature is obviously not the signature of the consumer, the original check would probably not be necessary in order to determine the validity of the consumer's claim. In that case, the consumer could not make a claim for expedited recredit under the proposed Act, because the consumer and the bank would be in the same position as they would have been had the original check been presented; that is, the consumer can show that the signature is unauthorized based on the substitute check that was presented. While the bank, in this case, may be obligated under other law, such as the U.C.C., to recredit the consumer's account for the unauthorized charge, the expedited recredit procedures of the proposed Act would not apply.

Claims for expedited recredit must be made within sixty calendar days of the relevant statement or substitute check being made available to the consumer, whichever is later, subject to extension for extenuating circumstances. This period for filing a claim for expedited recredit is consistent with the provisions of the Electronic Fund Transfer Act (EFTA), 15 USC 1693f(a) and 1693g(a), and the Board's Regulation E, 12 CFR 205.6(b)(3) and (b)(4). If a consumer fails to make a timely claim for expedited recredit, the consumer would still be able to make an indemnity claim within the period provided under section 9.

(b) How to make a claim--To make a claim, a consumer must provide to the bank holding the consumer's account a description of why the substitute check was not properly chargeable to the account or the nature of the warranty claim, a statement declaring that he or she suffered a loss, an estimate of the amount of the loss, the reason that production of the original check is necessary to determine the validity of the charge or warranty claim, and sufficient additional information that is necessary for the bank to investigate the claim. The consumer's bank may, in its discretion, require the consumer to put the consumer's claim in writing.

(c) Recredit to consumer--When a consumer makes a claim for expedited recredit, the consumer's bank must either produce the original check and show that the substitute check was properly payable, or must recredit the consumer's account for the amount of the claim up to the amount of the substitute check or \$2,500, whichever is less. The consumer's bank must take either of these actions no later than the business day following the banking day on which the consumer makes the claim. The bank must recredit to the consumer's account the remainder of the claim, up to the amount of the check plus interest, no later than the business day following the banking day that the bank determines the consumer's claim is valid, but no later than twenty business days after the banking day on which the consumer

makes the claim. Twenty business days are provided in recognition that the consumer's bank may itself file a claim against another bank, based on the consumer's claim. This would require additional time for the first bank to prepare the claim, and for the second bank to process the claim. Moreover, multiple banks could be involved--for example, if the second bank filed a related claim with a third bank--in which case still more time would be required.

The expedited recredit provisions attempt to strike a balance between, on the one hand, protecting consumers who have not agreed to have their checks truncated from problems associated with substitute checks and, on the other hand, protecting banks from fraud risks associated with expedited recredit claims. A problem caused by the use of a substitute check, such as a double debit caused by the presentment of the original check and a substitute check, could significantly affect a consumer's account balance if that check were a large-dollar check, such as a rent or mortgage payment. In these circumstances, a consumer may need expedited recredit so that other payments from his or her account would not be affected. On the other hand, banks desire protection against fraudulent claims and the possibility that a consumer would withdraw and abscond with the proceeds of an expedited recredit before the bank is able to determine that the expedited recredit claim is not valid. Banks also argue that they need sufficient time to investigate claims and to produce the original checks, if that is how they choose to comply with the requirements of this subsection. The Federal Reserve Board believes that a next-day recredit limit of \$2,500 is a reasonable compromise between banks' and consumers' interests. More than 97 percent of all checks written by consumers are for amounts of \$2,500 or less. The additional twenty days for recredit of the remainder of the claim should provide adequate time for the bank to obtain credit, or the original check, from an indemnifying bank. Despite the twenty-day period, banks have incentives to resolve claims as quickly as possible. For example, the consumer's bank would be subject to consequential damages under the U.C.C. for wrongful dishonor of subsequent checks if the availability of an expedited recredit for a valid warranty claim is delayed and results in wrongful dishonor of those checks.

Claims for expedited recredit are limited to the amount of the check plus interest. Expenses and other damages are not subject to expedited recredit but may be recovered through other provisions of the proposed Act when appropriate.

(d) Availability of recredit--Normally a bank must make recredited funds available for withdrawal by the start of the next business day after the business day that the bank is required to recredit the consumer's account. Earlier availability generally would not be operationally feasible, given the need for a bank to update its customer balances (for example, for ATM cash withdrawals) prior to making the funds available. A bank that receives a recredit claim from a consumer by the bank's cutoff hour on the first banking day must produce the original check or recredit the account on the second business day, and must make funds available on the third business day, except in cases where a bank may delay availability. A bank may delay the availability of the recredit, under certain circumstances, until the twentieth business day after the consumer makes the claim. The circumstances under which delayed availability is permitted are consistent with several of the circumstances under which delayed availability is permitted under the Expedited Funds Availability Act, 12 USC 4003(a)-(d), and the Board's Regulation CC, 12 CFR 229.13, specifically: (1) new accounts, (2) accounts that are regularly overdrawn (but not if the overdraft is related to the account charge in question), and (3) situations in which the bank has reasonable cause to believe that the claim is fraudulent. Under emergency conditions, the bank may delay availability for a reasonable period of time, provided that the bank exercises such diligence as the circumstances may require.

(e) Reversal of recredit--The consumer's bank may reverse any recredit provided under this section if it determines that the substitute check was properly charged to the

consumer's account. This subsection provides that upon any such reversal, the consumer's bank must provide to the consumer the original check and must notify the consumer of the date and amount of the reversal. Moreover, the bank must honor, for five business days after the notice and without overdraft charges, checks and other payments to third parties that would have been paid if the recredit had not been reversed, and must notify the consumer that the bank will honor such payments. No specific form or wording is required for the notices. These notice provisions are similar to those in section 205.11(d)(2) of the Federal Reserve Board's Regulation E.

There may be cases in which the consumer's problem with a substitute check can be resolved if the bank provides a better copy of the substitute check in question. For example, the consumer may have received a substitute check containing a blurry image of the front of the original paper check: In that case, the bank may be able to provide a copy of the substitute check with a sufficiently clear image of the front of the check that is sufficient to determine the validity of the charge to the account or the warranty claim. The consumer's claim in that case would no longer meet the requirements of subsection (a)(1)(c) of section 6, that is, it would be the case that production of the original check was in fact not necessary to determine the validity of the charge or the warranty claim. The bank would therefore be permitted, in such a case, to reverse the recredit to the consumer's account since the claim turned out not to be eligible for expedited recredit in the first instance.

Section 7. Expedited Recredit Procedures for Banks

(a) When a bank may make a claim--A bank is entitled to expedited recredit for a claim against a previous indemnifying bank if the following four conditions are met. First, the claimant bank (or a bank it has indemnified) must have received a claim for expedited recredit from a consumer under section 6 of the proposed Act or must have been subject to such a claim had the consumer's account been charged. Second, the claimant bank must have suffered a resulting loss or must be obligated to recredit a consumer's account under section 6 of the proposed Act. Third, production of the original check must be necessary to determine the validity of the charge to the consumer's account or the warranty claim. Fourth, the bank must have submitted the claim to the indemnifying bank within 120 calendar days after the date of the transaction that gave rise to the claim. For example, in the case of a double debit in which first a substitute check and then the original check are presented and debited, and a consumer makes a claim for expedited recredit from the claimant bank, the transaction that gave rise to the claimant bank's claim would be the presentment and debiting of the original check, which was the second of the two checks that were presented.

The 120-day provision is designed to provide sufficient time for claims to reach multiple indemnifying banks. If a substitute check is presented against a consumer account at the beginning of a statement cycle, the consumer may not learn of the debit for thirty days or more after the transaction. Additionally, the consumer has sixty days to make a claim and, if multiple banks handled the substitute check, it could take an additional thirty days for all indemnifying banks to receive a claim. The provision, however, applies only to the expedited recredit. Indemnifying banks continue to provide indemnities until the expiration of the statute of limitations in section 9.

(b) How to make a claim--To make a claim against a previous indemnifying bank, a bank must provide a description explaining why the substitute check was not properly chargeable to the consumer's account or explaining the nature of the warranty claim along with a statement estimating the amount of the loss incurred by the bank. The bank must also provide a statement that the original check is necessary to determine the validity of the charge or the warranty claim and sufficient information for the indemnifying bank to identify the substitute check and investigate the claim. If the consumer's claim against its bank is not in writing, an indemnifying bank may not require the consumer's bank to obtain

such a writing, but it may request a copy of the consumer's written claim if a written claim exists.

If the claimant bank in connection with its indemnity claim provides a copy of the substitute check in question, the claimant bank must take reasonable steps to ensure that the copy is not mistaken for the legal equivalent of the check under section 3(b) of the proposed Act nor handled for forward collection or return. This requirement is intended to prevent potential liability should a check copy unintentionally be reintroduced into the check collection or return system.

The amount of the claim subject to expedited recredit under this section is limited to the amount of the loss up to the amount of the check plus interest. The amount of the claim subject to expedited recredit does not include expenses or other damages but expenses and other damages may be recovered under the indemnity provisions of the proposed Act under certain circumstances.

(c) Recredit by indemnifying bank--Within ten business days of receipt of an indemnity claim from a claimant bank, an indemnifying bank must either provide to the claimant bank the original check or recredit the claimant bank for the amount of the claim, up to the amount of the substitute check plus interest. Ten business days should provide sufficient time for banks to research such a claim and produce the original check if it is available. If the indemnifying bank produces the original check, it has the same rights to the return of recredited funds as are provided in section 5(d). Because banks may vary the provisions of section 7 by agreement, a bank may agree to accept a copy of the original check rather than the original check itself.

Section 8. Measure of Damages

(a) Measure of damages--Unless otherwise provided in section 5 for indemnity claims, damages for breach of warranty or failure to meet any requirement of this proposed Act shall be equal to the loss suffered as a result of the breach or failure but not more than the amount of the check plus interest and expenses. "Expenses" includes costs, reasonable attorney's fees, and other expenses of representation. Damages are reduced by any amount the claimant has previously received as a recredit. An indemnifying bank may also be subject to additional damages (beyond the amount of the check plus interest and expenses) under certain circumstances.

(b) Comparative negligence--This subsection reduces the amount of damages a party may recover by any amount resulting from that party's own negligence or failure to act in good faith. In such a case, that party's damages are reduced in proportion to the amount of negligence or bad faith attributable to that party.

Section 9. Statute of Limitations and Notice of Claim

(a) Statute of limitations--This section provides that actions to enforce any claim under this proposed Act may be brought in any United States district court or in any other court of competent jurisdiction, and must be filed within one year after the cause of action accrues. This may result in some cases in an action being filed more than one year after the substitute check was created. The statute of limitations period under the proposed Act is consistent with the one-year statute of limitations provided by Regulation CC under the Expedited Funds Availability Act.

(b) Notice of claim--This subsection limits the rights of persons making indemnity or warranty claims under the proposed Act (other than certain consumers) who give notice of the indemnity or warranty claim later than thirty days after the claimant learns of the claim. Providing timely notice of a claim may reduce or prevent losses. Thus, an indemnifying bank is discharged for any loss caused by a delay of more than thirty days in receiving notice of the claim from the claimant bank. This provision is consistent with similar

provisions in Regulation CC and the U.C.C.

(c) Notice of claim by consumer--This subsection provides that a timely claim by a consumer for expedited recredit also constitutes timely notice of an indemnity or warranty claim by the consumer under the proposed Act.

Section 10. Effect on Other Law

This section provides that the provisions of this proposed Act supersede any provision of Federal or state law that is inconsistent with the proposed Act.

Section 11. Variation by Agreement

This section provides that the interbank expedited recredit provisions of section 7 of the proposed Act may be varied by agreement but that no other provisions of the proposed Act may be varied by agreement. This provision is intended to address the concerns of consumer groups that the proposed Act's provisions protecting consumers would be vitiated by permitting variation by agreement, given the general disadvantage of consumers in negotiating the rights and liabilities terms of their deposit agreements with banks.

Section 12. Regulations

This section provides the Board with the authority to promulgate regulations to clarify or otherwise implement the provisions of the proposed Act. The Board may also modify the requirements imposed by the proposed Act to further the proposed Act's purposes including but not limited to reducing risk, accommodating technological or other developments, and alleviating undue compliance burdens. This section also provides the Secretary of the Treasury with similar rulemaking authority with respect to Treasury checks. This section does not require the Board or the Secretary of the Treasury to promulgate such regulations. The rulemaking authority granted under the proposed Act to the Board is similar to that granted to the Board by the Electronic Fund Transfer Act.

The regulatory authority granted under the proposed Act recognizes that, over time, operational practices for collecting and returning checks are likely to evolve and permits the Board and the Secretary of the Treasury to modify the regulatory framework to keep pace with this evolution. For example, if the Treasury Department determines, based on technological, procedural, or legal changes, that it no longer needs to have truncated Treasury checks forwarded to a Federal Reserve Bank for safekeeping as required by the proposed Act, it could eliminate this requirement under its regulatory authority granted under the proposed Act. This regulatory authority, however, is not intended to permit the Board or the Secretary of the Treasury to exempt a particular class of checks from the proposed Act's coverage.

Section 13. Truncation of Treasury Checks

This section applies only to Treasury checks, and does not apply to checks drawn on accounts maintained by the Treasury at a commercial bank.

(a) Safekeeping of original Treasury checks--This subsection provides that banks may truncate Treasury checks and that banks that do so must send the originals of those checks to a Federal Reserve Bank for safekeeping. This provision addresses the Treasury Department's concerns about the requirement, arising from the *Cobell v. Norton* litigation, that it retain all checks. In addition, the provision improves the Treasury Department's ability to detect counterfeits and forged indorsements, which enhances its ability to allocate losses to the correct party. Properly allocating losses is particularly important to the Treasury Department because it does not have statutory authority to absorb a loss and issue a duplicate check.

(b) Not to be sent for forward collection--This subsection requires that, when sending

original Treasury checks for safekeeping, the truncating bank must send them in a manner that reasonably ensures that the original checks will not be mistakenly handled as forward collection items.

Section 14. Effective Date

This section provides that the proposed Act shall become effective on July 1, 2003, or one year after enactment, whichever is later. This period should provide sufficient time for the banking industry to adopt standards and procedures to fulfill the requirements of the proposed Act. This section also provides that the Secretary of the Treasury may extend the proposed Act's effective date with respect to Treasury checks. The Treasury has indicated that it is committed to enabling the truncation of Treasury checks at the earliest possible date. The Treasury, however, is currently engaged in transferring its check processing operations to a new platform and cannot at this time accurately predict an appropriate date for implementing truncation with respect to Treasury checks. The Treasury has indicated that the Secretary of the Treasury will publish a regulation extending the effective date for the proposed Act with respect to Treasury checks, if needed, as soon as it can specify a date certain.

¹ Throughout this document, the term bank includes commercial banks, savings institutions, and credit unions. *Depository bank* means the first bank to which a check is transferred even if it is also the paying bank or the payee. *Paying bank* means the bank, Federal Reserve Bank, or Federal Home Loan Bank by which a check is payable, or, to the extent it acts as payor of a check, the U.S. Treasury, the U.S. Postal Service, or a state or local government. [Return to text.](#)

² *Check truncation* refers to any of a number of arrangements in which the original paper checks are removed from the collection or return process before reaching either paying or depository banks, respectively, or reaching their customers. Currently under typical check truncation arrangements, electronic information about the truncated checks is presented to paying banks instead of the original paper checks themselves. Under the proposed Act, certain electronic information about truncated checks (electronic check images) could be used to create substitute checks, which could be presented to paying banks. Returned checks can also be truncated and processed electronically before they reach the depository banks and their customers; again, the proposed Act would permit the creation of substitute checks for return to depository banks. [Return to text.](#)

³ See Pub. L. No. 106-229, 114 Stat. 464 (2000) (codified at 15 U.S.C. § 7001 et seq.), at § 7001(d)(4); Unif. Elec. Transactions Act § 12(e) (available at www.nccusl.org). [Return to text.](#)

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